PRIVATE PENSIONS IN BULGARIA: COMMENTS AND RECOMMENDATIONS TO USAID/BULGARIA

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From: Lawrence H. Thompson

Subject: Draft Bulgarian Pension Law

Date: December 22, 1997

As requested, I have performed a quick review of the draft law on supplementary voluntary retirement pensions. It is not possible to tell from the current draft exactly what kind of institutions are being contemplated. In the absence of some clarification of this matter, it is difficult to make recommendations about ways in which the draft should be modified or amplified. There are, however, a number of places where approaches need to be clarified and issues need to be addressed.

The draft seems to contemplate institutions that mix together the functions usually performed by two separate institutions (or, at the least, by two very separate parts of one institution), an insurance company and an investment fund management company. One reason that these two institutions are usually separated is that they involve different operating styles and, as a result, different regulatory strategies have evolved for assuring both solvency and good performance.

The draft law speaks of collecting contributions to be invested and of paying retirement, survivor and disability benefits. It appears to contemplate the payment of (at least some)benefits in the form of annuities. What is not clear is whether this is essentially to be an insurance-based model with defined benefits or an investment-based model with defined contributions leading to annuity benefits in retirement. The differences between the two models are significant:

The insurance model involves a contract between the company (the new institution) and a insurance policy holder (the purchaser) under which the company promises to pay an amount that is specified in advance and is conditioned on: (1) the payment of one or more premiums by the purchaser and (2) the occurrence of a specified event (death, disability, or attainment of a particular age). The promised payment may be either a lump sum or a monthly benefit. The insurance company makes a profit by collecting more in premiums than it must pay out in benefits (after deducting its investment earnings). Competition for business among insurance companies can sometimes become destructive, however. One regulatory challenge is to prevent competition among insurance companies from causing companies to quote a price that is too low (so that it subsequently threatens their solvency) and/or to subsequently make it too difficult for policy holders to collect on the policy. Another is to assure that assets are invested wisely so that policy promises can be met.

In the simplest form, the size of the financial promise made to the policy holder is not dependent on the financial performance of the insurance company's investment portfolio. Thus, the policy holder usually had no particular interest in how well in company's investment portfolio behaves, *as long as the company remains solvent*. The assurance of solvency rests on three pillars -- the adequacy of the actuarial projections underlying the pricing of the insurance products, the quality of the firms investment decisions, and the size of the shareholder's capital which provides an additional cushion to assure payment.

In this model, actuaries play a critical role in establishing the company's financial plan and assessing its adequacy. They estimate the future liabilities that the company is taking on when it sells each policy, calculate the prices that must be charged for each product, and compute the amount of financial reserves that the company needs to hold in order to assure that it can make the contracted payments.

Where the interests of the policy holder and the company diverge is over the specifics of when the company must pay benefits, since the policy holder will want payment terms interpreted as loosely as possible and the company will want payment terms interpreted as tightly as possible. Regulators must be careful, therefore, to assure that it is clear how premium payment conditions are to be met and how the occurrence of the event that triggers payment (particularly disability) is to be established.

In the insurance model, key regulatory issues include: (1) consumer protection, which mainly involves supervision of the terms of the insurance contract and of the mechanism to be used for settling disputes arising from its interpretations, and (2) solvency regulation, which mainly involves assuring that products are priced adequately and that the company's policy and shareholder reserves are adequate to assure the payment of promised benefits.

The investment fund model involves a contract under which the investment company undertakes to manage funds that have been entrusted to it by its clients. Although claims of high returns are common when promoting its products, the company typically makes no particular contractual promise about the value of the payment that the individual will receive upon the attainment of a particular age (or death or disability). Rather, the client is simply entitled to the accumulated balance in his account at whatever point in time the client is allowed to withdraw it. The investment company makes its profit by charging a management fee which is typically specified as a percent of each new contribution and/or a percent of the total amount of the assets being managed.

The lack of a defined promise of a future benefit is a key difference between an investment fund and an insurance company. Because there is no set commitment as to the amount that will be paid in the event of retirement, death or disability, there is no role for actuarial calculations and no great need to worry about whether the worker makes regular payments into his account. Similarly, since the company's liability is limited to the amount in each individual's account, there is far less need to worry about objective definitions of the events that trigger payment (especially disability). (Indeed, the party that is most concerned about an objective definition of when a qualifying disability has occurred is likely to be the government owing to the consequences it has for computing income tax liabilities. Both the client and the investment company are likely to be perfectly happy to agree that it occurs whenever the client says it occurs.)

In the insurance model, the policy holder has little direct interest in the size of investment returns, but in the investment fund model, the size of the returns is his primary concern. Under this model, primary regulatory attention needs to focus on the investment policies to be followed. One approach is to allow investors to police the system themselves by making sure they are offered a choice among portfolios, that there is full disclosure of the investment policies that are being followed under each portfolio, and that investors are able to switch options or account managers whenever they disagree with the actual investment decisions. Another approach is to tightly regulate the kinds of investments that can be made to assure that investors funds are managed for the benefit of the investor. The second approach may be more appropriate where there are relatively few investment instruments and investors are inexperienced. As capital markets mature, however, they inevitably migrate toward the first model.

The shareholder's reserve plays a different role in the investment model than in the insurance model. In the investment model, it assures enough capital to finance the start-up costs of the enterprise and provides a cushion in the case of fraud. It is not a protection against unfavorable investment returns.

Regulators will need to keep an eye on administrative charges in this model, at least until the market matures and the investors become experienced in evaluating the different competing options.

The draft law. In what follows, I will assume that the framers of the law have in mind one of two possible ways that these institutional models can be used to produce pensions. Depending on which model they have in mind, they will need to clarify the institutional arrangements roughly along the lines outlined below. (If what they have in mind doesn't resemble one of these two models, I'm not sure what they're trying to do.)

The first model is an insurance company which essentially sells to the worker each year a single payment deferred annuity.[1] At retirement, the worker is entitled to a total monthly payment which is the sum of the individual annual annuities he has purchased. In this model, the investment risk is borne by the firm rather than the individual. This model was a popular way of providing pensions before World War II in a number of countries, but is now less common than the second model.

If this is the model to be followed, additional clarification will be needed about:

- how the survivor and disability protection is to be provided. This model only produces a full retirement pension when annuities have been purchased in each working year prior to retirement. The model will not produce a full benefit in the event of death or disability prior to retirement. The only way to get a full disability or survivor's benefit is to establish a separate term insurance contract for each and deduct a portion from each year's retirement premium (which portion will grow as the individual gets older) to support the continuation of coverage through that year. In this model, if contributions cease, disability and survivor coverage will lapse and the individual is left with only a partial pension in retirement.

- who will have the power to review and approve the terms and conditions of the annuity contracts? Will they have the authority to prohibit the use of unapproved contracts?

Certain provisions of the current draft law seem incongruous with this model, however:

- there is no particular reason to regulate administrative fees as such (Art 23); these would be a part of the actuary's general calculation of the price that needed to be charged for a particular product.
- it's not clear what an actuarial evaluation of investment policy is supposed to be. Actuaries make assumptions about investment yields, but tend not to be investment advisors also.
- it's not clear what business these companies are going to be in if they can't invest reserves or sell annuities; why are the investment license (Art 6.2 and Art 22) and annuity license (Art 6.3) optional?

The second model is a combination of the investment funds discussed earlier and annuity

[1] Since the law seems to contemplate a direct relationship between the pension supplier and the individual, the classic employer-financed, defined benefit supplemental pension seems to be ruled out. That model is only effective when financed by an employer on a group basis.

issuers. The investment funds accumulate contributions made during an individual's working life and invest them in financial instruments. When the individual reaches retirement age, the total accumulation is available to be converted into an annuity. The investment firm operates on a defined contribution basis and makes no promises about the amount of money that will be available when the individual retires. In contrast, the annuity firm promises a specific monthly benefit for the rest of the individual's life. The two firms are separate legal entities. This is the model used today in most of the world (e.g., the mandatory private pension components of Poland, Latin America, Sweden, etc. and well as most of the voluntary individual accounts in the U.S.)

If this is the model to be followed, additional clarification will be needed about:

- the survivors and disability benefits mentioned in Article 9. In the investment fund model, death or disability can be events which allow an individual early access to his fund balance. They will not trigger a monthly payment, however, unless specific provision is made for the purchase of disability and survivor term insurance from a separate insurance company (as discussed previously).

- who will be custodian of the securities owned by the investment fund. To reduce opportunities for fraud and mismanagement, securities should be held by an organization that is a totally independent legal entity.

- what rules will be used to assure full disclosure of investments to the individual account holders and the regulators? What minimums will be established to assure diversification of assets? Who will enforce these rules and how will the do it?

- what provisions will be established to allow people to move their business from one firm to another without suffering a tax penalty? Will some minimum period of notice (e.g. up to -- but no more than -- 30 days) be required (the U.S. model) or will there be some limit on the number of times the account can be moved in a given period of time (the Latin American model)?

Certain provisions of the current draft law seem incongruous with this model, however.

- what is the role of the "administrative company" discussed in Art 3?
- investment companies don't need actuaries (Art 3) and wouldn't need an actuarial report (Art 7)
- investment companies shouldn't need detailed rules on when somebody can move their account (Art 8.2); with suitable notice, one ought to be able to leave at any time.
- investment funds don't have "retirement reserves" to guarantee fund solvency (Art 15)
- it's not clear what business these funds are in if they're not in the business of

investing reserves (the license is optional in Art 6 and Art 22).

- the limit on administrative costs is far too high. Any fund whose costs come anywhere close to 10 percent of assets is going to be paying negative returns in most years.

Whichever model is selected, certain other items need clarification:

- If employers are allowed to make contributions on behalf of their employees, are there any rules about nondiscrimination among employees? Are there rules governing commitments to continue to make payments as long as the individual is employed? Who owns the assets if the individual leaves the employer? (e.g., when do benefits vest?)

- How will disability be defined?

- Will there be any mechanisms for resolving disputes other than a trip to the courts (Art 34)? An administrative tribunal with the authority to deal proactively with problems might be a more efficient and effective approach.

- What tax treatment is contemplated? Although reference is made to "tax relief" in Art 33, there needs to be a clear strategy for the tax treatment of contributions, investment returns, and benefit payments.

- Will annuitization be mandatory? Will married persons be required to buy joint and survivors annuities? Is it contemplated that annuity benefits will be indexed? If so, how will that be financed?

- The minimum capital provision (Art 16) may provide a reasonable starting place, but (particularly if the insurance model is being followed), minimum capital reserves have to be related to the size of the assets or liabilities of the firm.

- It is not clear what Article 20 refers to. One should not start talking about additional guarantees without a clear understanding of what they are, who provides the financial backing, how they will work, etc. It is also not clear what is contemplated by section 2 of Article 20

- Do the insurance and investment regulators have the power to demand operating and investment information at any time? Can they issue cease and desist orders to prevent the continuation of questionable practices without waiting for litigation to proceed through the courts? Do they have the power to force diversification of investments and limit the exposure to particularly risky investments (such as commercial real estate)? Do they have the information and authority needed to prevent conflicts of interest (e.g., investment in firms owned by the people who own the insurance or investment company)?

19 February, 1998

Sofia, Bulgaria

To:	**John Tennant, USAID Bulgaria** **Bill Foerderer, USAID Bulgaria** **Malory Greene, USAID**
From:	Martha Kelly
Subject:	**Assessment: Pension Reform in Bulgaria**

The following is the assessment of the current situation of pension reform in Bulgaria prepared in anticipation of the USAID Bulgaria office issuing a Technical Assistance project in response to a request from the Minister of Labor and Social Protection (MOLSP).

A list of technical recommendations to be included in a Technical Assistance project has been prepared as a separate document.

The referenced attachments were provided to Dontcho Barbalov.

c.c.: Dontcho Barbalov

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Executive Summary

USAID is well positioned to assist the Minister of Labor and Social Protection (MOLSP) at a critical point in the reforms to strengthen and expand the private pension funds of Bulgaria. The Minister's request coincides with three other government initiatives underway in Bulgaria of which the pension funds are at the center: reform of the social security system, second round of the issuance of the mass privatization vouchers and development of the capital markets. These issues relate to, have direct impact on and are inseparable from the reform of the private pension funds. Thus, this assessment comprehensively addresses their interrelationships and influences on the USAID project.

Pension and Social Security Reform

A properly drafted private pension fund law will ensure protection of workers' contributions made to private pension funds, establish the framework for regulation of activities of these firms and design incentives to stabilize and grow both worker participation and contributions.

A Working Committee

[1] made up of government officials and representatives of private industry and non-governmental organizations (NGOs) has been tasked to reach agreement on policy issues and to prepare the draft law described above.

The World Bank proposes through a Social Protection Adjustment Loan (SPAL) to assist the MOLSP in the reforms of the Bulgarian social security system. This issue is under consideration by the Working Committee as well. Their proposal, summarized in the *Aide Memoire* referenced in the attachments, outlines a three-step recommendation similar to that of the recommendations to the USAID Technical Assistance. These recommendations are:

Strengthen the existing private pension funds (a fully funded system of voluntary contributions to individual accounts).

Reform the current social security system by: indexing benefits; linking benefits and contributions; improving collection and administration; creating compliance incentives; and adjusting benefit formula for disability, early retirement and varying risk categories of workers.

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[1] The Working Committee was organized by the Center for Economic Development (CED). The Committee is chaired by Y. Hristoskov, former MOLSP and currently President of the NGO, Ekonomika 2000. The Committee members include: N. Slavchev, representing private pension funds; E. Miroslavov, an MOLSP pension attorney working on the draft law; E. Jichev and I. Nikolav, representing the SEC; D. Ninov, representing the MOF; and V. Etugov, a Parliamentary Secretary.

Redirect a portion of existing mandated contributions into a system of private pension funds (a proposed plan to have a fully funded system of mandated contributions to individual accounts).

A solid collaboration and coordination of these projects between multiple donor agencies would strengthen a USAID project.

Mass Privatization Vouchers

The use of mass privatization vouchers has been proposed as a means to achieve two results: induce additional workers to participate in the private pension funds and provide a means to distribute vouchers once again to the general public but unlike the first round not using the privatization funds.

Capital Markets Development

The development of the capital markets is another issue of importance to the endeavor to strengthen the private pension funds, as there is an urgent need for expanding investment for the workers' contributions. In all countries today the single largest dependable source of cashflow into capital markets is from fully funded systems of individual accounts. Bulgaria indicates no sign of proving the exception and therefore capital market expansion is directly linked to the expansion and growth opportunities of the private pension funds.

Interim USAID Action

The administrative and procurement preparation of this Technical Assistance will take between four and six months before selection of a contractor had been made (unless the project is sole sourced) and the project work has begun. In the interim, however, USAID must ensure that work within the scope identified continues on several key tasks. If not, the risk to USAID is that a law will be passed which is different from the strategy recommended and that goals will not be achieved.

The law is expected to be redesigned and passed during a time when the USAID project will not be in progress and before the World Bank will have begun its technical support. There is risk of losing momentum and accurate direction that was gained in the last six months and the two public workshops on 12 and 13 February 1998 in Sofia.

As an interim step USAID should either dedicate a senior staff member to complete the following of have the assistance provided independently.

Continued participation in the technical design of the private pension funds and in the interaction between the current project, the project for the social security reforms, mass privatization voucher distribution and capital markets project

Continued assistance and participation to the Working Committee:

Review, assess and prepare written responses on Iain Batty's draft law comments (and on the next few sets of comments, four sets expected over the next three months)

Review, assess and prepare written responses on the Main Goals and Principals of the Supplementary Pension Insurance, dated 22 January 1998 (at this point comments are overdue and should be made without further delay)

Assessment of Current Situation

Overview

Currently Bulgaria has a program allowing pillar three contributions

[2] on a voluntary basis. This is a supplemental program to the current pillar one state administered pay-as-you-go system

[3]. There is currently no pillar two system operational.

The voluntary pension system has been in existence for three years. Seven firms ranked in order of the size of assets under management serve the market:

Bulgaria Voluntary Pension Fund Ltd.
Doverie Pension Insurance Company
Sagliase Pension Insuranse Company
Bulgarian Pension Company
Social Security Fund Sila Ltd
Cooperative Pension Insurance Fund

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[2] The three pillar system referred to is described in the pension reform model published by the World Bank in, Averting the Old Age Crisis, Estelle James, et al (1994 and subsequent supplements). The model consists of contributions made by either workers and employer/enterprise or solely by workers. Pillar one: mandatory contributions to a defined benefit system; pillar two: mandatory contributions to individual accounts for each worker; and pillar three: voluntary contributions to individual accounts for each worker. While the structure of pillar one may or may not permit private investment management, assets accumulated under pillars two and three are almost always privately managed by investment professionals.

[3] The pay-as-you-go-system, frequently a type of defined benefit plan, is a generic term for pension systems which pool the contributions of many contributors and a guarantee a benefit to workers/affiliates (or survivors) upon attainment of age, years of employment or other requirements based on a predetermined formula. By comparison, systems based on the concept of fully funded individual accounts pay a benefit to workers/affiliates (or survivors) based on the accrued value of the account. In the first type, plan benefits are a function of the payment formula; in the second, benefits are a function of the sum of contributions and earnings. The first are said to be output driven; the latter are input driven. The responsibility of financing the payments rests on the government or employer/enterprise in the first scenario and on the worker/affiliate in the second scenario.

Energy Pension Fund

The system has poorly structured incentives and as such participation is low, about 350,000 participants contributed last year, which is 10% of the working population.

The private pension fund industry evolved in Bulgaria in advance of regulatory structure and oversight. Now the government has an immediate need to put in place important protections for the workers' long term retirement funds. The system grew into an open, non-standardized, loosely organized group of fund companies with little similarity reinforcing pension benefits.

Typically private pension funds must meet a standard to become licensed and maintain certain levels of services or transaction volume to continue to participate as a firm. This is not currently the case in Bulgaria. While the Association of Private Pension Funds is quick to point out that they are fully licensed (under the Ministry of Trade and Commerce) that has nothing to do with ensuring the long-term protection of the workers assets. These funds are in an awkward position as they must try on their own to reinforce an image of stability and maintain professional standards by promoting that they technically meet the licensing obligations set forth by the government. Nonetheless, the government has not passed a law with proper regulations and as such they are not regulated in accordance with an international standard for private pension funds.

Thus, the first step is agreement on the following issues and the preparation and passage of a law to support them.

Minimum requirements/standard definition to become a private pension fund

- Define specific services to be completed, e.g., accept contributions, allocate and track transactions by tax-exempt status, credit earnings, and describe the process by which the services will be validated by the Supervisory authority
- Define fund organization status, e.g., joint stock company, partnership, simple corporation; minimum qualifications to be officers and executives; and disclosure of affiliations with related businesses
- Require segregation of the workers' contributions from the assets of the organizing/managing company for security and solvency protection purposes
- Define the amount of initial and ongoing capital reserve requirements

Statement that all previously licensed firms must reapply to be licensed and follow the same process as newly licensed firms (no grandfathering permitted)

Standardize fees, costs, reporting

Public Opinion Survey

To further substantiate the importance of the need to strengthen the private pension fund companies, the Sagliase fund recently had a market research firm complete a survey in which public opinion was polled of workers who did *not* participate in a voluntary pension fund.

The most common reasons cited were:

There is no law to protect the funds	60%
There is no government agency to supervise these companies	70%
There is no licensing requirement or standard by which to maintain a license	60-70%

Occupational Funds

The government recently approved a program of occupational funds in which contributions are already underway. This first occupational fund applies to teachers and is funded in theory by redirecting a 3% contribution from pillar one. Nothing is set-up, however, and no contributions are in fact being redirected from pillar one into anything else.

One of the benefits of developing a system of multiple privately managed pension funds is the competitive environment in which workers are permitted to select among private pension funds. By mandating that certain occupational groups use only selected funds that competitive benefit is lost. Thus if the government is pressured to allow the occupational funds and the Technical Assistance project is compelled to support it, a condition should be added that all private pension funds, whether or not associated with an occupational orientation, should:

Meet the same technical requirements to be granted a license
Meet the same minimum capital reserve requirements
Permit unlimited transfers (or permit transfers at least once a year) between private pension funds without cost, penalty or restriction to the worker
Operate within the same transparent rules of fees disclosures, investment return reporting and service description requirements

Such a compromise will permit the occupational and union groups to provide a better program to their members, if in fact they are able to, but avoid a system of occupationally imposed substandard programs that once locked into members are not free to "shop" for the best services, rates and fees.

Tax Incentives

The tax-exemption of a voluntary pillar three contribution is currently limited to the first 30% of minimum wage that is contributed; minimum wage is 50,000 leva per month. This amount is far below international standards and undermines the government's need to build participation and improve asset growth.

To expand the pillar three voluntary contributions the USAID project should support:

Increase the voluntary contributions limits up to 10% of wages
Match the tax-exemption to the amount contributed

Until this January enterprises were encouraged to make contributions on their workers' behalf through an incentive which allowed the enterprise a tax-exemption and encouraged worker-matching contributions. The government eliminated the tax exemption incentives against the recommendations of the enterprises and the private pension funds apparently with little understanding to their impact that these contributions would most likely cease to be made without the tax savings. To return employer contributions to a source of viable contribution flow to the third pillar funds would require a tax-incentive program.

The issue of tax-exempt status of contributions to private pension funds has been managed in the past through the income tax law and separate from any connection to the social security or proposed private pension fund law, and as such this should be coordinated with the reforms as well.

Incentives to Decrease Evasion

One of the strongest *indirect* benefits of mandated contributions being redirected from a pillar one pay-as-you-go system to a system of fully funded individual accounts is that evasion from the primary social security system is drastically reduced. In the Bulgarian pay-as-you-go system a worker who cheats by undercontributing weakens the system but is not individually penalized whereas in a system of individual accounts the worker who cheats only penalizes himself and not the system.

The pay-as-you-go system in Bulgaria is plagued with rules that provide incentives to workers to underreport or fail to report wages. A worker who failed to disclose full wages was not penalized through lower payouts as there was no linkage between a worker's history of contributions (generally 25 to 30 or more years of accumulated contributions) and that same worker's benefits; thus why report?

Through a series of improvements begun in the last three months by the NSSI a linkage is being created between contribution and benefits but it will take years for this change to be felt by the average Bulgarian worker.

On a more immediate basis within one year of redirecting mandated contributions to pillar two fully funded individual accounts each worker receives a statement reflecting contributions for the previous year. If that worker has underreported wages then a smaller contribution has been accumulated in that worker's name and there is produced an immediate incentive to fully report. While old habits do not change overnight, the Chilean system reports almost 96% compliance rate

[4] with payment of all social security taxes of employed workers. By comparison in Bulgaria the compliance rate was 30% in 1997 and a rate of 47% is projected for 1998 for all non-state-owned enterprise-employed workers. State-owned enterprises project fewer new jobs while private industry is projected to significantly increase the number of employed workers.

Regulation of Private Pension Funds

The issue of regulation of private pension funds is important as it provides an opportunity to the government to demonstrate to the people that pension contributions will be protected. As workers are already contributing to these funds, the government cannot afford to delay this issue longer. Should anything happen to anyone of the private pension funds while this debate is underway a political mess will ensue potentially with claims that officials stood watch as a crisis to workers' long term savings once again was permitted to occur.

Proper regulation in Bulgaria balances the short-term need of immediate supervision and regulation with the longer-term needs of the best method of completing the task. This is a case where timing needs demand greater attention.

While there is a unanimous consensus that there must be an immediate passage of a pension law and creation of regulations for private pension funds, two scenarios are being debated on who will regulate these funds:

Use existing regulatory bodies for supervision of the three primary areas of responsibility: NSSI for pension issues, SEC for investment of assets and investment policy and insurance commission for payments to beneficiaries and survivors in which the payment is in the form of a guaranteed annuity. This is not the most efficient method but can be instituted on relatively short notice. Also, it provides for consistency in the areas of investments and insurance regulation. Further, it appears to be the method that will be accepted by the Working Committee.

Create a new regulatory body for supervision of all three areas. This will take considerably longer time and thus defeat one of the main reasons to move forward at a fast pace with reforms which is to provide immediate oversight and supervision.

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[4] Annual report of the Superentendencia de AFPs, Santiago, Chile 1997.

It has been estimated that the delay would be up to one year before a new Supervisory function could be constituted and be fully operational, the timeframe of creating the SEC was used as an example; that too took 12 months.

Investments

The first rule of pension investment is diversification. Together with a long-term time frame the private pension funds' key role is to ensure the proper balancing of diversification and market risk assumptions to achieve an optimal return.

A properly designed investment policy will permit an adequate range of investment options to allow the private pension funds the ability to protect the accumulation in the workers' accounts against inflation eroding the purchasing power of benefit payments. No such investment policy exists today in Bulgaria, nor do market conditions exist to support such a policy. <u>Nonetheless workers' contributions continue to be funded everyday and need to be managed within an adequate policy</u>.

Given the difficult position of needing to diversify but having relatively few domestic options available, we recommend that a transition plan be developed. Such a process would entail the development of a properly diversified policy but permit a phased in approach to its implementation together with allowing a small percentage of the funds to be invested in foreign markets until the domestic market capacity is expanded.

There are a number of factors favoring a small percentage of foreign investment:

Trends. Increasingly pension reforms include limits on foreign investment as a means to allow diversification beyond the domestic economy. Hungary permits up to 30% of the contributions; Chile up to 20% (but less than 5% is currently international); Mexico up to 100% (but less than 10% is currently international); Bolivia up to 50% (but less than 2% is currently international); and Argentina up to 10% (but less than 5% is currently international).

Diversification. The Working Committee members realize that the workers' wages are related entirely to the domestic economy, the pay-as-you-go system solely relies on the domestic economy and increasingly workers are demanding the opportunities to seek a small amount of diversification.

Improve portfolio. By allowing expansion into international markets the Working Committee can allow greater quality of the portfolio holdings, greater liquidity and experience an opportunity for greater investment returns.

Currently the ability of the Bulgarian private pension funds to invest the contributions is extremely limited: 85% of monthly contribution flow must be invested in short-term government bonds and at all times the portfolio must be comprised of 40% or higher government bonds. The international market is not demanding the leva denominated Bulgarian government bonds, rated Bb, which is what the pension funds are invested in thus, further restricting the private pension funds from being able to trade them on the secondary markets. A further impediment to the private pension funds ability to invest outside this narrowly controlled scope. The remainder of funds is generally invested in bank certificates of deposit.

The nascent capital markets is the primary reason for such a limited scope of investment but again to grow the funds and strengthen workers' confidence in the system, a proper investment policy will need to be developed. Several initiatives are underway on a related infrastructure expansion to boost the Bulgarian capital markets.

An international standard is to develop a properly diversified investment policy and provide certain trigger-point capital market development issues to begin to require adherence to the policy under a phased-in transition plan.

A well-diversified investment policy will stipulate:

Mix of securities between:

- Equities
- Bonds
- Real Estate
- Cash

Within each asset category there will be international and domestic limits.
Within each asset category there will be quality standards and ranges.
Within each industry there will be concentration limits.
Within each security there will be concentration limits.

We recommend that requirements be included to ensure that all securities are custodied by an *independent* custody agent. For cost, consistency of settlement procedures, and supervisory oversight simplicity the government should consider selecting a single international custodian through an open bid. To select multiple custodians for such a small market would greatly undermine the cost to worker issue and to select a single firm without benefit of an international bid would sacrifice competitive selection. Both alternatives should be avoided.

Another discussion was whether the Central Depository would be appropriate group to compete as the sole custody agent. Further research is needed to assess this situation. Most recently the Central Depository role was expanded to include functions of clearing and settlement for all shares traded in Bulgaria. The question of whether there is appropriate separation of duties and responsibilities for audit and control purposes to consider that the Central Depository is acting as a transfer agent and custody agent on the same transactions should be studied.

Use of Vouchers from Mass Privatization Program

The use of vouchers from the mass privatization program has been suggested as follows:

Under the program one voucher valued at 250,000 leva will be issued to each qualifying adult, about 6.5 million vouchers issued altogether. During the last round of vouchers, only about 3 million were exchanged either directly for shares of companies or indirectly through the privatization funds. In this round the government has expressed a preference to avoid the use of privatization funds are at considering instead that workers will be encouraged to deposit vouchers with private pension funds. It is not known what the tax-exempt status of the worker's income will be to offset a contribution to a private pension fund. It was explained that a credit will be made to the worker's account in the amount of 250,000 leva as a contribution. It is not known the cost to the private pension companies to modify their systems and operations to accept non-cash contributions.

Under the proposed scheme, private pension fund portfolio managers will exchange the vouchers for shares of the privatized companies. If the portfolio managers are permitted to swap vouchers for shares based on their own assessment and research then the portfolios may be expected to "purchase" from among the best companies. If not, and managers are required to "buy" an index portion of all privatized companies, there is concern over the quality of the companies being privatized and thus being forced into the pension funds.

A two-for-one exchange scheme designed to encourage and reward workers who use vouchers as a means of long-term investment, as presumably shares of privatized companies will not be liquidated until retirement has also been discussed. As portfolio managers buy and sell company shares every day in response to market conditions and the portfolios cashflow needs based on many factors not just the issue of benefit payments.

The government has raised an option that it may use the voucher program with the private pension companies as the only means of exchanging vouchers for shares other than on a direct basis. The privatized funds used in the first round of privatized shares distribution will not be an option for workers to exchange shares. If this is the case, there is great concern among the financial industry that scores of firms will attempt to become licensed as a private pension fund prior to the establishment of stringent criteria for private pension firms. To avoid such exploitation of workers, pension contributions and a potential disaster of private pension collapse, the government should permit the voucher program to proceed only once the private pension law has been passed.

Finally, if the private pension funds are the main means of voucher for share exchange it can be expected that up to another 2.5 or 3 million accounts will need to be opened, managed and processed. Such a significant explosion of activity would overwhelm the existing system and should be managed in a planned and orderly manner. To return to the initial recommendations, the existing system must be strengthened immediately.

Fees and Costs

The new law and regulations should provide improvements to bring the fees and costs in line with international norms. This can be done through changing disclosures, requirements of reporting and in setting one method of fees assessment (thus requiring all firms to quote fees similarly).

Bulgarian workers are assessed relatively high fees to account balance ratio in comparison to similar programs in other countries. In 1996 for example most workers paid fees between 6% and 10% of *assets under management*. By comparison in Latin America that range is between 3% and 4% of *salary* and in the US and Canada the fees range between 1% and 2% of *assets under management*. There are a number of reasons that account for this disparity in fees, many of which are not within the control of the private pension funds, but are a function of the low contribution amounts and the small number of participants due to government limits on tax-exemptions. The funds announced that last year's fees declined but as this information is not required to be furnished publicly until April, it could not be validated. Regardless, there remains considerable room for improvement.

Currently in Bulgaria private pension funds do not compete on cost, rate of return or the level and quality of customer service; all factors which greatly affect pricing in other markets. This is due primarily to the lack of regulation of a standard, easy-to-understand layperson comparison of standard reporting of:

Fees
Investment Returns
Services

Instead the current system requires that disclosures be given to each worker affiliated (insurance contracts) which are not easily understood by the layperson. Fees are inconsistently charged, e.g., some firms charge a flat asset fee, others both an asset and percentage of contribution fee. Fees are not consistently quoted for the same services. These combined factors produce a difficult to understand program yet the private pension funds can accurately claim they are within the prescribed disclosure requirements of the law.

Three factors directly relate to costs borne by each private pension funds: fixed cost, which *will not vary* based on the number of participants affiliated; variable costs, which *will vary* based on the number of participants affiliated; and market forces, competition.

It's the variable costs that can be reduced with an increase in the number of workers affiliated to the system and the fixed cost that can generally be reduced by a streamlined processing system. Market forces drive competition for better prices.

Draft Law

There is a now a proposed law under draft by the Working Committee to set regulation and create minimum standards in an effort to better organize these funds, afford worker protection of their long term savings and begin the development process related to more fully diversifying investments of contributions.

This draft law has been widely circulated and commented upon by the three related groups:

Government: MOLSP, Ministry of Finance (MOF), National Social Security Institute (NSSI), SEC, Insurance Commission

Private industry: CED, Private Pension Fund Association and each private pension fund named above, Bulgarian Actuarial Society, Bulgarian Industrial Association, Bulgarian Chamber for Commerce and Industry, Bulgarian National Bank, Central Depository

Trade unions: CNSB, FRGO, Podkrepa, FTUI, Ekonomika 2000, Union for Private Economic Enterprise

Iain Batty, a pension attorney with experience in drafting private pension fund laws in other countries in the region was recently secured by CED on behalf of the Working Committee to assist in what is being considered the final version of this pension law. His comments are included as an attachment.

Financial Services Crisis

The overall confidence level by the public needs to be improved in order for private pension funds to be trusted.

The private pension fund association is in a unique position to understand first hand the complexities of today's program in Bulgaria, constraints and opportunities to improve it. Yet their efforts are regarded suspiciously and with mistrust by government officials and the general public. The financial services sector is not highly regarded by Bulgarian citizens for a number of reasons:

There is a history of ponzi and pyramid schemes in Bulgaria in which thousands of families lost all their savings and had no recourse.

Bank failures of last year led to many more citizens losing all their savings; although the government bailed out some banks which survive today the citizens have been left with the impression that all of the financial institutions, but most especially banks, are neither well managed nor well capitalized.

When given the opportunity Bulgarian financial institutions have not always acted in their customers' best interest. A good example is the behavior of the management of the privatization funds. While no evidence has been put forward that these funds violated the law, their behavior violates international standards of proper fiduciaries [5].

Imposing extraordinarily high fees on customers who were locked-in to their privatization fund and not permitted to leave or transfer to another privatization fund

Executing transactions without regard to fees imposed by intermediaries which resulted in lower transaction costs inuring to the benefit of the privatization fund owners in other areas of business

Almost all of the private pension funds are related by subsidiary or parent company relationship to a privatization fund, a bank, an investment brokerage firm and/or an insurance company. While there is nothing wrong with these relationships in general, it reinforces a perception of continual incestuous relationships.

The lack of confidence in the private pension funds is further compounded by the fact that the government has little experience regulating them. There is as much criticism and fear of the private pension funds having to be regulated by what they allege to be incompetent officials and staff as the government officials dread having to regulate an industry which they fear is on the verge of illegal activities at any moment.

Both sides have demonstrated an unlimited capacity to overreact and to become involved in each other's business.

Public Communication Campaign

Bulgaria needs to develop a program that allows keys officials to learn from the Working Committee as the program progresses. Information is constantly being exchanged but accurate information is hard to disseminate on which to then receive feedback. Further the Working Committee will be required to gain a consensus at the Parliament level in order to ensure proper support for the passage of the law.

The work groups of other governments have successfully employed a detailed workplan to manage expectations and begin making presentations to key constituency

[5] Fiduciary behavior is the generally accepted practice that firms and individuals managing pension assets must act in the best interest of the participants/survivors above the interests of the firm.

groups defined as:

Members of Parliament
Journalists, and media in general
Associations of enterprises, workers unions, retiree special interest groups, etc.

From this point the information can spread to the public through multiple channels and is strengthened by the messages reinforced by other groups:

Government creates its own public awareness campaign
Members of Parliament also send messages of their involvement and support
Unions back their key issues
Journalists have created their own issues to support
Private pension companies begin advertising campaigns to gain market share and promote the incentives added to the program

Overcoming Problems

The USAID sponsored Technical Assistance Project should respond to the following problems:

Low participation in private pension programs

Low participation has a negative impact any pension reform in that economies of scale of managing these programs cannot be met. Without economies of scale, costs are not reasonable, enough competitors cannot afford to enter the market and encourage competition in the form of improved services and better investment returns.

By permitting the redirected contribution from pillar one to pillar two to be made into the same private pension funds as are currently receiving pillar three, quicker participation growth can be achieved. This also acts as a tremendously strong incentive to gain the full cooperation of the private pension funds to make immediate changes that will be required under the proposed draft law.

A primary goal should be to carry out programs to address the lack of confidence in the private pension funds, lack of understanding of the benefits, lack of incentives to enterprises and workers to participate and the need to protect against fraud. By improving the participation rate many benefits are achieved such as lower demands on the state system, greater citizen control to gain financial independence, and development of a predictable flow of funds available for capital markets investment. Finally, with increased participation there is a higher level of public awareness and quality being demanded which protects the system (the "all for one" concept).

The tools to overcome these problems include the development and passage of the pension law, regulations, and supervisory authority.

Worker account balances subject to erosion

Another critical issue is to address the factors that erode account balances.

Another benefit to permitting the redirected contribution from pillar one to pillar two to be made into the same private pension funds as pillar three contributions, is to more quickly achieve average participant account size growth.

The lack of a diversified investment policy imposes risks of account value erosion through failure to outperform inflation, failure to preserve capital and failure to seize opportunities that will ensure growth. In Bulgaria it is all but impossible for workers to select private pension funds based on comparisons of the levels of fees or the investment performance as there is no adequate policy of standard disclosures of fees and investment performance return which permit workers to make such comparisons. Finally there is a need to educate the workers on the benefits of increasing contribution levels.

In addition to the tools mentioned above, the development and adoption of a diversified investment policy, establishment of minimum standards and transparent disclosures combined with market forces and development of coordination among regulatory authorities can be effective.

Operations of Privately Managed Pension Companies

The model of privately managed pension funds has undergone considerable modification by each country to best suit their pension system needs. But among almost all of them are related services and methods of generating fees. It is these services which are regulated and for which fees are paid by the workers.

A summary of the services typically provided in Bulgaria includes:

Services of the Private Pension Companies to Enterprises and Workers

Affiliation or enrollment into the program

This service includes communication and education and the means to do that typically consists of mass advertising or targeted promotions in newspapers, magazines, television, billboard and customized brochures and literature. Most funds including the firms in Bulgaria use a sales force of agents who are responsible for one on one selling. The largest private pension firm in Bulgaria has 105 separate offices which are staffed with thousands of sales agents (similar information was not readily available on other funds). The more competitive the environment the higher the private pension company fees may be allocated to these services in an effort to gain and retain market share.

Recordkeeping Functions

One of the more complex functions of the private pension funds is to accurately and efficiently receive, process and report millions of worker and enterprise transactions annually.

In Bulgaria, which is typical of most other countries, the private firms establish one account on their computer system for each enrolled worker, or participant. Monthly contributions representing worker pre-tax voluntary contributions are forwarded for processing to the private pension funds. Each employer/enterprise may forward contributions to more than one private firm each month. The number of transmissions is a function of how many different private pension funds the workers have authorized to receive their voluntary contributions.

For example one enterprise has 150 workers and half have affiliated with one private firm, one quarter with another firm and of the remaining 40 workers five each affiliated with three other firms and 25 do not authorize contributions. This enterprise would originate and submit five separate transmissions and aggregated contribution deposits the five private pension funds.

As contributions are tax-exempt up to the first 30% of the minimum wage the private pension funds are already relied upon today to distinguish the taxable versus tax-exempt status of contributions.

Additionally in Bulgaria the private pension funds may accept contributions from the enterprises on behalf of the workers. The pension contracts may also provide for matching worker contributions. These additional contributions must also be tracked by taxable and tax-exempt status and further, the enterprise contribution is typically monitored for a vesting schedule. Enterprise contributions, with or without matching worker contributions, typically are forwarded to the private firms for processing quarterly.

Earnings

Earnings are also calculated and paid to worker accounts monthly.

Segregating Pillar Two and Three Contributions

The rationale for segregating contributions by different type of private pension fund has been described as an easy method to maintain two standards for contributions. The argument for two standards, however, is not a good one for Bulgaria. The contributions which workers are obligated to make as part of the overall social security system, pillar two should not be higher than the standards for voluntary contributions. This higher standard has been suggested in types of investments, benefit payment options and even in the capital reserve requirements.

But this is Bulgaria. If the government were to publicly announce a *higher* standard of protection for worker contributions in the form of more stringent review and quality of investments, benefit payments and reserve requirements it is unlikely that there would ever be another contribution made under pillar three as a voluntary contribution.

Instead it is recommended that all contributions be afforded the same, *higher* protections while correctly distinguishing and tracking contributions at more competitive fees and costs.

Further it has been argued that to permit pillar two and three contributions together will require computer systems capabilities to distinguish between different tax exemption status. Typically, pillar two contributions are regarded as EET (exempt at time of contributions, exempt at time of earnings accrual but taxable at time of payment of benefits). By contrast many countries have different tax exemption status for pillar three. Regardless of the final combination decided for pillar three contributions, the existing private pension funds already distinguish contributions by different tax exempt status as indicated above.

The cost of segregating contributions must be examined. If costs are explained as indicated below, then there is no cost advantage to maintaining the segregation by different financial institution. As the argument above explains segregation by contribution type and tax exempt status can be maintained.

Cost per participant pillar two	1 x cost			
Cost per participant pillar three	1 x cost			
Total	2 cost	**OR**	1 1/3 cost	Cost per participant with combined pillar two and three

Issuing Benefits

The private pension funds calculate and pay benefits and may be responsible for distinguishing in payments the tax status.

The private pension funds are required to calculate and pay benefits when the participant has retired, becomes disabled or when the participant dies. The options available include lifetime annuity that can be either a fixed or variable benefit; single payment; or settlement option.

Issuing Participant Statements and other Reports

Currently the private pension funds issue an annual statement to workers presenting an historical record of transactions of contributions from enterprises and earnings and benefit payments.

Revenues of Private Pension Companies

Currently Bulgarian private pension funds impose fees by three methods:

Fees based on a percentage of assets under management which is netted each month before earnings are credited to each worker's account (gross earnings minus fees equals net earnings)

Fees based on a percentage of salary or contributions, or a front-end load fee, is commonly used in many countries but appears to be used by only a few Bulgarian private pension funds

Transaction or plan level changes fees appears to be used on an ad hoc basis and is related to changes in the contract terms between an enterprise and fund

Another method used in some countries is to charge a fee for each benefit payment but there does not seem to be use of this fee in Bulgaria.

Communications and Supervision of the Private Pension Companies by Regulatory Authorities

NSSI

This agency, part of the Ministry of Labor, is responsible for running one of the largest programs in Bulgaria. From a sheer numbers impact it is estimated that currently the majority of households are receiving some benefit from NSSI: short term assistance to households, pension, disability, maternity, work employment training, unemployment, etc. They are huge in size and only in the last two years were made independent of MOLSP directly and as recently that they began to manage their own budgets (independent of the Bulgarian National Treasury).

NSSI monitors some data on some workers but in no way is it prepared to assume a role to establish and maintain computer records of individual accounts for 3 million workers. The data necessary to be tracked would include worker name, address, date of birth, tax identification number, employer/enterpise affiliation number, beneficiary information and updating all this information as it changes.

Yet this has been proposed. It is not viable and in discussions with the NSSI with senior level management they commented that this notion was incredible. As they explained, only recently did they start to have enterprises account to them the number of workers by age range and by sex with social security taxes. Thus their system will report a male, between the ages of 50 and 60 made a contribution on wages between 200,000 and 250,000 leva for last month. This is no integrated participant recordkeeping database system, nor can it become that overnight.

It is the head of the NSSI that appears to favor a plan that either the NSSI establish private pension funds, process all recordkeeping transactions and computer records as described above or regulate the private pension funds. Perhaps the role of regulator can be a compromise. To be able to recommend whether the NSSI would make a good supervisory role would take additional time to assess.

SEC

The SEC is most anxious to play one aspect of the supervisory role of the private pension funds. It appears to be a logical fit with all parties (except the insurance industry) and as it is new and unencumbered by old ways of doing things this may work well.

Also the role of the SEC would be important as the issue of the use of vouchers proceeds.

Insurance

The insurance industry is strongly related to the private pension funds, as the most common form of payment from the voluntary contribution benefit programs is an annuity. Currently only firms that are licensed as insurance companies are permitted to underwrite risk and sell annuities. The private pension companies would like to be able to be licensed to sell annuities as well and as such there has been enormous debate on this issue. The position of the private pension funds is that if they meet the requirements of minimum capital reserves to underwrite the risk and make guarantees of payments then they too should be granted licenses. The insurance industry is not in favor of this.

The insurance commission has been identified as the appropriate group that should supervise the functions of the benefit payments of the private pension funds if they pay annuities. There has been no mention of another group to supervise the activities of the funds if they are paying benefits outside of the scope of a guaranteed fixed or variable annuity.

Office of Budgets and Forecasting

This group, part of the Ministry of Finance, is responsible for projecting and balancing contributions to and benefit payments from the pillar one system. They have provided realistic numbers that reflect the urgent need to reform the pillar one system. They appear to have a good grasp of the issues and provided a brief assessment of the status of the problems of today's system if it is not changed. The attachment indicates the macro economic issues and is fairly recent.

We do not recommend that they be part of the regulatory/supervisory process of private pension companies whether there are pillar one or two contributions. They similarly have no interest in that role.

Role of the Employer/Enterprise

The interests of the enterprises must be factored into the program as well or they will not support it or worse may even encourage its evasion.

Most enterprises initially consider the programs allowing them to make contributions on their workers behalf as a means to attract and retain good workers due to improved benefits. The next factors, which are evaluated by employers on whether to participate in a system, are cost and resources allocation related. The examples given above illustrate the recordkeeping duties imposed on enterprises to monitor worker selection of a private pension company. The enterprises will consider their own ease of administration by demanding one simple standard method of forwarding contributions.

Finally, enterprises are generally wary of programs and demand reassurance through reports and confirmations to allay their concerns of fraud and corruption.

In Bulgaria there also appears to be leveraging of relationships with related businesses of the private pension funds' other financial services. For example one private pension company that is also owned by a bank may offer to a business enterprise the opportunity for more favorable loan rates if that firm selects the bank's related private pension company to direct its contributions. While I received several comments from those with whom I met that this relationship is dishonest and could be used in a dishonest manner, for all practical purposes it is practiced universally.

Scope of Issues

Proposed issues to be included in the Technical Assistance Project:

Pension Law and regulations: MOLSP and the Working Committee have outlined a reform timeline that the law will be passed within two to four months by the time this Technical Assistance is assigned. If that is not the case the first order of the Technical Assistance should be to assist in its passage. Regardless of when the law is passed it should set the regulatory framework for the supervision of the funds.

Investment Policy: Development and design of a fully diversified investment policy by which the private pension fund must manage the investments of the workers' contributions. This would include phased-in implementation recommendations to accommodate the privatization voucher issues and the nascent status of capital markets development in Bulgaria.

1. Privatization vouchers: Coordination of the use of vouchers with simultaneous projects in capital markets development and mass privatization efforts underway by the government. There are two issues surrounding the use of vouchers: the quality of the underlying investments and the costs to the worker. Permitting workers to deposit their vouchers (in lieu of tax-exempt cash contributions) into the private

pension funds is motivated by the government's concern that they have no other method to distribute shares of recently privatized funds. While this method may appear to initially offer a relatively short-term solution to a rather complex problem, in fact such a proposal creates a more significant problem than the one it appears to assist. In a meeting of the Working Group Evgueni Jichev, Director of Investment Companies for the Bulgarian SEC, indicated that to require an obligatory acceptance by the private pension funds would be equivalent to forcing the funds to invest in risky investments. Such a policy is inconsistent with recommendations that USAID's project assist in ensuring improved security of worker account balances. Further, the private pension funds are processing cash contributions today. To require acceptance of non-cash contributions (vouchers) is to impose an operational change to the private pension funds, which cost would be born by the workers for a one time only occurrence. This should be studied further as the cost seems to outweigh the benefit in this case.

Other alternatives are available which do not increase cost to workers through operational changes, by requiring suspiciously high-risk investment and by ensuring greater diversification.

Pillar two contributions: The government needs to establish a second pillar system of mandatory contributions to fully funded individual accounts that are privately managed. Ideally contributions will be redirected away from the existing social security program, called the pay-as-you-go system. If contributions are redirected then a logical place for them to be invested is in the private pension funds. The pillar two contributions appear to be a conditionality issue with the pending World Bank loan and should complement the conditionality issues of the Technical Assistance project.

Minimum standards: Development of regulations which define the minimum standards of specific services of the private pension funds and conformance with:

Definition of requirements to establish a private pension fund
Minimum capital requirements
Licensing of agents of the private pension funds
Disclosures to regulatory/supervisory authorities and their abilities to inspect, report and access information on-line and on-site
Disclosures to public in general: workers and enterprises
Advertising and promotion standards for financial investment returns, transparent and fair quoting of guaranteed rates and disclosing actual fees collected

Minimum standards of recordkeeping and transaction processing, worker and enterprise reporting requirements is proposed as part of the goal to help ensure the safety of the workers' account balances.

Conflict of interest policy: Development of a policy and proper supervision guidelines would go a long way to reinforcing the safety of workers' contributions into these accounts. The policy should extend to all aspects of private pension funds, their subsidiaries and parent company relationships. Policy development, its enforcement, and reporting of such transactions and fines are all needed.

Benefits: Development of benefit payment issues should look at standardization issues among all private pension funds. The regulations should describe calculation methodology requirements for retirement; survivor and if permitted early retirement options. The methods of benefit payments should also be defined as standardized as an annuity (fixed or variable payment), single sum payment or a settlement option.

Contributions: Development of a system of incentives to encourage participation is a function of contributions and their tax status as much as it is the safety of accounts and the diversification of the investment policy.

Worker or enterprise maximum contribution limit
Tax-exemption status and limit
Earnings and tax status

Related Programs

World Bank

The World Bank recently completed a mission in December, 1997 and presented to the MOLSP an *Aide Memoire*, which outlines a series of recommendations to improve the social security system. One aspect of these recommendations is the proposed changes to the pillar one system and redirection of a portion of the contribution to a newly formed pillar two system. A table follows at the end of this document that illustrates current contributions to the pillar one, two and three system.

The World Bank recommendations were reinforced by Mihael Rutkowski and John Innes of World Bank social sector for Eastern Europe who participated in the meetings organized by USAID to validate a number of the proposed discussion points of this paper. The meetings were 12 and 13 February and were held first with the Working Committee and the following day with a broader audience led by John Tennant, Yordan Hristoskov and Minister Neikov.

UNDP

The UN is in the process of completing a training program for social security offices on improving and streamlining claims processes. The final program will also include other training and they are interested in being able to have some overlap and reinforcement of the pension fund program

Phare

Although EU Phare previously had social security reform programs designed to automate and streamline pension benefit claims, we were unable to meet with them and are unaware of specific programs they advocate in the future.

ILO training

The International Labor organization also currently has training programs underway to support the field offices which work with retirees who make benefit claims, unemployment claims and in other NSSI oriented household relief programs.

IMF Program of Extended Fund Facility

The IMF also currently has an ongoing program in Bulgaria related to improving the economic feasibility of improving the debt payment problems of the state. They have a keen interest in the USAID program as they are concerned if the pillar one and two reforms are not made quickly there will be negative effects on the government's continued foreign debt problem.

Background

I met with individuals involved in the pension reform issues of Bulgaria, which were critical to validate the hypothesis of the above recommendations. A list of completed meetings is attached.

I had the benefit of reviewing a collection of background documentation completed by the groups supporting related programs. This documentation included:

Correspondence from Ivaylo Nikolov, Bulgaria Securities and Stock Exchange Commission, dated 12 February 1998

Correspondence from Venolin Rakovski, Chairman of the Private Pension Fund Association of Bulgaria, dated 9 February 1998

Comments on Pension Law Revision, February 1998, Cameron McKenna/Center for Economic Development from Iain Batty

Act on the Additional Voluntary Pension Insurance Articles 1 through 18 (incomplete translation) provided by MOLSP

Correspondence from Minister Ivan Neikov to John Tennant, USAID Resident Representative, Sofia, Bulgaria, not dated. Also an attached version of the proposed law (different than the one cited above), dated 5 December 1997

Bulgaria: Social Protection and Adjustment Loan *Aide Memoire* from World Bank Mission, December 1997 (mission on social policies, reform of social security system and voluntary pension system and labor related issues)

Report from Raiffeisen Investment Phare Advisory Team at the CMP, January 1998 (vouchers program and related privatization issues)

UNDP Bulgaria Economic and Human Development Background, 1996 (general background on economic activities and impact of reforms and other policies for the last 10 years)

Suggestions an (sic) Comments to a Draft of Act on the Supplementary Pension Provision, dated 13 February 1998 submitted by Vladimir Kaishev, President of the Bulgarian Actuarial Society

P Comparison (internally prepared and not for official distribution) of the fees, services and transfer restrictions imposed by the top five Private Pension Companies prepared by Doverie, February 1998 (no data has been verified by USAID)

Reform in the Social Security System, prepared by Mariella Nenova, et al. National Social Security Institute (NSSI), Sofia, Bulgaria, not dated

Bulgaria Social Security and Voluntary Pension System: Current Contributions and Benefits

	Worker Category	Pillar I	Pillar II	Pillar III
		Mandatory Contributions	Mandatory Contributions	Voluntary Contributions
		NSSI Administered	Private Pension Fund	Private Pension Fund
	Worker Category	Managed in PAYGO	Managed in Fully Funded Individual Accounts	Managed in Fully Funded Individual Accounts
	I	52% + 2%	0%	up to 30% of minimum wage can be a tax-exempt contribution (unless such tax-exemption is already used for health care of unemployment contributions)
	II	47% + 2%	0%	
	III	37% + 2%	0%	
Output Factors Replacement Ratios	Worker Category			
	I		0%	0%
		28% to 32% of average final salary		
	II		0%	0%
	III		0%	0%

Proposed changes: reform pillar one to lower contributions over time; create pillar two by redirecting a portion of the mandated contribution from pillar one; and increase the allowance of voluntary contributions under pillar three closer to an international standard of 10% of wages, with the tax-exempt amount being equal to the amount of contribution.

Pillar one contributions are expressed in two parts to represent the portion funded by the enterprise and worker, respectively. There is no replacement ratio expressed from pillar three to indicate how government officials view it. Although the Association of Private Pension Funds expressed it differently, the figure was not substantial, nor uniformly quoted.

Bulgaria Social Security and Voluntary Pension System: *Proposed* Regulatory Supervision and Three Primary Function Areas

Pension

Regulatory Authority
NSSI or a new agency

Functions
Affiliate/enroll workers
Accept contributions
Process transactions
Issue statements
Calculate and issue benefit payments
Provide customer service

Investments

Regulatory Authority
SEC or a new agency

Functions
Manage investments in accordance with investment policy
Develop investment objectives
Report earnings

Benefits

Regulatory Authority
Insurance Commission or new agency, only on the portion related to underwriting risk assumption of benefits

Functions
Annuity: fixed or variable
Single sum payment Settlement option (non-annuity multiple payments)

19 February, 1998

Sofia, Bulgaria

To:	**John Tennant, USAID Bulgaria** **Bill Foerderer, USAID Bulgaria** **Malory Greene, USAID**
From:	Martha Kelly
Subject:	**Technical Recommendations: Pension Reform in Bulgaria**

The following is a list of technical recommendations to be included in a Technical Assistance project on pension reform in Bulgaria.

Technical Recommendations for USAID Pension Reform Project

This technical recommendation is the second part of a two part deliverable. It provides a list of recommendations that the USAID project should include to support the efforts of the Bulgarian government to complete a two phase pension reform.

The first step is to make secure the institutions that have evolved absent a strong regulatory environment and the second step is to direct new contributions into the reformed, strengthened system.

The first step must be completed to allow the public's confidence of the system of private pension funds to improve. Then, when mandated contributions are directed to privately managed funds, the public's trust will be properly placed. Without first securing the financial institutions it will be impossible to gain public support to redirect contributions. The privately managed pension companies cannot grow and successfully be sustained without a dramatically improved level of contributions. Thus this is the importance of the second step to be taken on an immediate basis.

Although each task is explained separately, it is one united project. Different aspects support and reinforce each and the government's need to strengthen the financial institutions and to improve the viability of the programs.

As explained in the assessment, these programs are inseparable; it is not recommended that these projects be divided or taken out and put into another project for purposes of losing consistency and separating the intention and strategy of this project with the strategy of other projects.

Improve the existing system

The first step is the preparation and passage of a law to secure private pension funds. The law should include:

- Develop minimum requirements/standard definition for a firm to become a private pension fund
  - Define specific services to be completed, e.g., accept contributions, allocate and track transactions by tax-exempt status, credit earnings, and describe the process by which the services will be validated by the Supervisory authority
  - Define fund organization status, e.g., joint stock company, partnership, simple corporation; minimum qualifications to be officers and executives; and disclosure of affiliations with related businesses
  - Require segregation of the workers' contributions from the assets of the organizing/managing company for security and solvency protection purposes
  - Define the amount of initial and ongoing capital reserve requirements
- Develop process that all previously licensed firms must reapply to be licensed and follow the same process as newly licensed firms (no grandfathering permitted)

Standardize methods of imposing fees (not amounts of), define allowable costs which can charged to a fund's participants and what must come from a fund's revenues, define standardized reporting disclosures for the average person to understand

Develop regulations which define the minimum standards of specific services of the private pension funds and conformance with:

Develop minimum requirements to license agents of the private pension funds
Create disclosures to public in general: workers and enterprises
Develop advertising and promotion standards for financial investment returns, transparent and fair quoting of guaranteed rates and disclosing actual fees collected
Develop standard method of calculating and paying earnings
Develop standard methods of accepting contributions form enterprises
Develop standard required data for inclusion on participant account statements
Develop standard requirements for collection of private pension company fees

Develop pillar two contribution process by redirecting a portion of contributions from the existing social security program, called the pay-as-you-go system. Develop a separate set of benefit payment rules of benefits paid from pillar two contributions from private pension funds to ensure consistency and compliance with pillar one benefit rules.

Develop a program to standardize benefit payments between private pension funds, but allow for differences between pillar two and three contribution payments

Recommend benefit payment options for pillar two and three contributions separately.

Define standard methods of benefit payments as an annuity (fixed or variable payment), single sum payment or a settlement option.

Develop program of uniform benefit payment options, which includes defining the payments, tax status and disclosure of fees associated with each option.

Develop separate rules for calculation of benefits paid from private pension funds from pillar two contributions.

Include calculation methodology requirements for retirement; survivor and if permitted early retirement options.

Develop policy to identify transactions that are in conflict of interest. Develop regulations and filing/disclosure requirements to supervisory authorities

Coordinate the trade union, occupational and private pension funds together

If trade unions, occupational funds will exist under the new program a condition should be added that all private pension funds, whether or not associated with an occupational or trade union orientation must meet the same requirements:

Meet the same technical requirements to be granted a license

Meet the same minimum capital reserve requirements

Permit unlimited transfers (or permit transfers at least once a year) between private pension funds without cost, penalty or restriction to the worker

Operate within the same transparent rules of fees disclosures, investment return reporting and service description requirements

Create and standardize tax incentives

Create a program within the laws and regulations to ensure a system of tax incentives to increase participation and improve the contribution rate.

Increase the worker voluntary contributions limits up to 10% of wages
Match the tax-exemption to the amount contributed
Return employer contributions to a source of viable contribution flow to the third pillar funds through tax benefits.
Define earnings and tax status

Malory Greene: Note that you will need to connect the issue of tax-exempt status of contributions to private pension funds. In the past tax exempt issues were handled through the income tax law.

Create Supervisory Process Over Private Pension Funds

Identify functions that must be supervised.

Identify which governmental agencies, existing or new, which can best meet supervise these functions.

Organize and standardize supervisory procedures between agencies so that private pension companies make one set of reporting functions.

Define how the authority(ies) are authorized to make supervisory review.

Identify regular reporting requirements of the private pension funds to the appropriate supervisors.

Identify penalties, fines and regulatory action, including revoking of licenses for firms that fail to comply with supervisory authorities.

Define appeal processes of funds that wish to appeal supervisor rulings.

V Develop Investment Policy

Develop a well-diversified pension investment policy:

Mix of securities between:

- Equities
- Bonds
- Real Estate
- Cash

Within each asset category there will be international and domestic limits.
Within each asset category there will be quality standards and ranges.
Within each industry there will be concentration limits.
Within each security there will be concentration limits.

Develop a phased-in transition implementation plan in accordance with capital markets development.

Develop requirement for creation of an *independent* custody agent to hold and maintain custody records.

VI Use of Vouchers from Mass Privatization Program

Develop a procedure on the use of vouchers by the private pension funds.

VII Develop Competitive Fees and Costs Program

Develop a regulation of an easy-to-understand layperson comparison of standard reporting of:

Fees
Investment Returns
Services

VIII Develop a Public Communication Campaign

Design and employ a detailed workplan to manage expectations and begin making presentations to key constituency groups defined as:

Members of Parliament
Journalists, and media in general
Associations of enterprises, workers unions, retiree special interest groups, etc.

Begin the communication plan to target the following actions:

Government creates its own public awareness campaign
Members of Parliament also send messages of their involvement and support
Unions back their key issues
Journalists have created their own issues to support and champion
Private pension companies begin advertising campaigns to gain market share and promote the incentives added to the program